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RUCNASE/ASEAN MEMBER COLLECTIVE  
RUEHKO/AMEMBASSY TOKYO 0261  
RUEHBJ/AMEMBASSY BEIJING 0179  
RUEHRO/AMEMBASSY ROME 0782  
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SUBJECT: Korea's Finance Ministry Floats a Mini-"Big Bang"

SUMMARY

1. Korea's Ministry of Finance and Economy (MOFE) has launched an impressive new raft of regulatory reform measures in the early months of 2006. According to ministry plans, regulations governing financial services will be cut drastically, with barriers separating traditional business domains eliminated or significantly reduced. Foreign financial service providers have welcomed the new measures as evidence of the Korean government's intention to try to make good on the promise inherent in the "financial hub" vision originally outlined by President Roh Moo-hyun when he took office three years ago. End Summary.

MOFE PROPOSES SIGNIFICANT FINANCIAL REGULATORY REFORMS

2. The Ministry of Finance and Economy formally announced a series of new financial regulatory reform measures on February 19, after having foreshadowed the action through a number of previous public statements starting in early 2006. Announcing the initiative, Korea's Deputy Prime Minister in charge of finance and the economy, Han Duck-soo, proclaimed that "The twin pillars of the Act are opening and competition, with the purpose of giving financial firms a freer hand in the development and marketing of products."

3. According to MOFE's plans, the current six major laws individually governing each sub-sector of the financial system will be merged into one, while breaking down barriers between business lines. Meanwhile, the number of regulations applied to financial services will be reduced in both number and impact, with the number of rules to be cut from the current 300 regulations to only 190 relevant rules. The ministry explains that the new deregulation steps are a result of its "Zero-base Financial Regulatory Reform

Review," which took place in 2005.

¶4. Financial shares rose sharply on the news of the ministry's reform plans, with listed securities companies seeing increases in share prices in the 10-12 percent range on February 20, the next trading day, even as the market overall grew just one percent that day.

¶5. The key piece of legislation to bring to life MOFE's dream will be a new "Capital Market Consolidation Act," which MOFE will submit to the National Assembly in the second half of 2006, aiming for entry into force in 2008. According to MOFE, the Consolidation Act will aim to fundamentally reformulate the legal framework that has governed Korea's capital markets for the last 43 years, ever since the enactment of the Securities and Exchange Act in ¶1962. MOFE promises that the legislation will revamp Korea's existing regulatory system by (to the extent possible) switching from positive-list to negative-list regulation of financial services. In addition, the new rules should go a long way toward eliminating sector-by-sector division to allow more "universal" financial services business models.

¶6. For example, under the Consolidation Act, non-bank financial institutions will be empowered to manage and market more versatile products, freely deciding what sort of assets to include in each investment portfolio. Investment banks will also be allowed to engage in a variety of financial services ranging from investment banking to wealth management, securities services and futures. MOFE also pledges that, with its new rules, investors will enjoy improved investor protection, "on a par with that of the

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advanced economies," while being furnished with improved investment opportunities into new and diverse financial products. Corporations raising funds should also be able to utilize a wider range of financial sourcing methods tuned to their specific needs.

¶7. MOFE notes that its legislation will be at least loosely modeled on Australia's Financial Services Reform Act of ¶2001. The legislation also draws inspiration from the United Kingdom's "big bang" reforms of the 1980's, which helped make London into the key financial services center of Europe.

ANATOMY OF A MINI-"BIG BANG"

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¶8. In May 2005, MOFE established 13 public-private task forces to study the benefits of a "zero-base" financial regulatory reform initiative, and to conduct a comprehensive review of Korea's regulatory situation. Altogether, the task forces reviewed 40 financial laws and decrees, including 639 individual regulations. Of that total, the 13 task forces identified 101 laws, decrees and rules that could be improved or eliminated, including 85 that need extensive modification, 13 recommended for elimination and 3 items marked for later review. The ministry also created its own "zero-base regulation reform task force" charged with pushing things forward, while keeping the public and industry informed.

¶9. Taking inspiration from the Prime Minister's Regulatory Reform Committee, the MOFE teams conducted a "zero-base" re-examination of the need to keep each regulation. Importantly, the teams were tasked to review Korea's financial regulations from the perspective of the parties to be regulated, rather than the perspective of those who regulate -- the more typical approach. The groups' philosophical mandate stated that they should:

-- Overhaul irrelevant, redundant or excessive regulations that restrain creative activity by the private sector;

- Streamline or eliminative ineffective regulations;
- Lower barriers to entry for financial firms;
- Improve equality among the various financial business sectors; and
- Enhance international integrity to stay in line with global standards.

¶10. Among the specific results of the "zero-base" review, the experts recommended the following major regulatory changes:

- Permit solicitation by insurance planners and investment consultants;
- Permit indirect investment funds to invest in credit derivatives for hedging purposes;
- Permit banks to buy and sell commodity derivatives and financial derivatives;
- Ease regulations on foreign currency asset management ratios for insurance companies;
- Ease regulations on loans to the same borrower by mutual savings banks;

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- Lower regulatory thresholds for establishing financial holding companies;
- Lower entry barriers for the credit rating business;
- Expand the criteria for issuers (originators) of asset-backed securities;
- Ease approval requirements for controlling shareholders of insurers;
- Ease restrictions on opening branches for mutual savings banks; and
- Abolish the securities issuer registration system.

¶12. Meanwhile, the Consolidation Act will merge Korea's Securities and Exchange Act, Futures Trading Act, and other capital market-related laws under a single law. Some of the major elements of this proposal include:

- Financial Services Deregulation: Current restrictions that strictly separate securities, futures, asset management, trust services and other financial services businesses (excluding banking) are to be removed to allow financial services companies to offer multiple financial services;
- Broader Scope for Financial Investment and Products: Financial investment and other related products are to be broadened from the current "positive list" system, which enumerates what is allowed, to a "negative list" system that enumerates what is not allowed, to encourage greater investment and better financial products; and
- Deregulation of Indirect Investment: Current restrictions that recognize only trust investments (in the form of beneficiary certificates), corporate-type investment companies (mutual funds), and private equity funds as indirect investment vehicles are to be removed so that other entities recognized under the Commercial Code can be included as indirect investment vehicles.

COMMENT: PROSPECTS FOR SUCCESS

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¶13. Some local critics have noted that barriers to business linkages between the banking and securities sectors were eliminated over 20 years ago in several leading Western markets -- making the Korean rules changes not so much courageous as overdue. Even so, foreign financial service providers have welcomed the new measures as evidence of the Korean government's intention to try to make good on the promise inherent in the "financial hub" vision originally outlined by President Roh Moo-hyun when he took office three years ago.

¶14. Overdue or not, MOFE's reform plans are timely. Domestic financial institutions need to re-position themselves to take better advantage of demographic changes and the excess liquidity currently sloshing around Korean financial markets. The Korean government has reason to hope that the newly-announced reforms will lead to the genesis of homegrown investment banks and asset management firms that will be fully-equipped for global competitiveness.

¶15. The Consolidation Act and MOFE's other deregulation initiatives are certain to be closely examined in the National Assembly, precisely because the legislation could

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have a major impact on various Korean financial institutions, especially banks and insurance companies. Weaker Korean banks and some insurance firms will likely seek to water down or slow down MOFE's proposed changes, both before and after it submits legislation to the National Assembly. It is also possible that other ministries will seek to retard the initiatives, seeing them as a MOFE power grab. However, given the Roh Administration's apparently strong commitment to the initiative, and the widespread sense in Korea that financial sector reform is still a work in progress, which needs to be pushed farther forward, the Embassy remains sanguine that at least the lion's share of MOFE's dream will see the light of day.

¶16. A final observation: The new round of financial reforms is also well-timed for U.S.-Korea bilateral economic relations. Our bilateral discussions on financial services reform in the U.S.-Korea Free Trade Agreement talks -- if handled in such a way as to complement MOFE's plans -- could provide a useful adjunct to MOFE's own campaign for reform. Still, we should be careful to make sure that the two efforts proceed in parallel, but not directly-linked tracks, so as not to allow nationalism to become a counter-argument to MOFE's self-initiated reform measures.

VERSHBOW